This situation can occur because regulators sometimes employ the practices of one firm as a benchmark, or yardstick, for others.[60] Thus, for example, Ameritech's practices may serve as a benchmark for other RBOCs, including SBC. Ameritech will ignore this fact in determining whether to adopt a particular practice so long as the two companies are separate. After the merger, however, the combined company might be reluctant to introduce an improved practice that raised its profits in, say, Illinois if regulators required the same practice to be employed in, say, Texas, where it would otherwise be unprofitable for SBC. Prior to the merger, of course, this external effect would be ignored.[61]

In support of their position, Gilbert and Harris also claim that "SBC has also demonstrated quality improvements as a result of its merger with Pacific Telesis. SBC significantly improved quality in repair times for the PacTel area.[62] It is not clear, however, that the improved quality can be attributed to the merger. As Gilbert and Harris concede, the California Public Utility Commission (CPUC) imposed performance requirements on the combined firm as a condition for CPUC approval of the merger. If the improvements had been instituted by SBC without any

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[60] A detailed analysis of the effect of the merger on the ability of regulators to employ benchmarking is contained in the Declaration by Professor Farrell and Dr. Mitchell, which is summarized in Section 8 below.

[61] Ameritech and SBC may, however, already be taking into account the fact that regulators in the states they serve benchmark their operating subsidiaries against one another. The point here is that the merger might further reduce the incentives to adopt certain practices because it would increase the number of operating entities that the merged company controls and that might be forced to adopt these practices.

[62] Gilbert and Harris Report, Para. 60.

pressure from the CPUC, further analysis of the circumstances might be warranted. However, the willingness and ability of the merged company to meet a minimum standard mandated by a regulatory authority hardly seems to qualify as a merger-related efficiency.

Our analysis suggests that the merger would not facilitate the diffusion of cost-saving best practices, and that some cost-increasing best practices that would be adopted pre-merger would not be adopted post-merger.

5.3 Economies of scope and scale and purchasing economies

Gilbert and Harris provide few specifics on the nature of economies of scope and scale that might result from the merger. As one example, Gilbert and Harris identify "rationalizing repair and maintenance facilities over a combined firm, lower cost purchasing and the attainment of scale economies in administrative functions" as sources of the economies of scope and scale, which the merging parties claim will produce projected cost savings of $1.43 billion.[63] The merging firms, however, serve territories that are non-overlapping and in large part disjoint. It, therefore, is doubtful that they own extensive redundant facilities and that they are likely to realize substantial scale and scope economies by rationalizing telecommunications facilities across these territories. Economies of scope with regard to maintenance and repair *facilities* might be realized if two adjacent areas were combined. If the proposed merger is approved, SBC's service areas will extend in patchwork fashion

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[63] Gilbert and Harris Report, Paras. 39-40.

from California to Connecticut. It is unclear that repair facilities in California will be of much use in Illinois, let alone Connecticut. However, SBC and Ameritech repair and maintenance facilities in Missouri and Illinois, respectively, might provide some limited opportunity for achieving economies of scope. If so, then absent the merger, SBC might be a likely potential entrant into Illinois and Ameritech into Missouri.

In discussing specific sources of cost savings, Gilbert and Harris claim that there may be substantial gains to the merged company from its ability to consolidate the separate outsourcing and purchasing activities of SBC and Ameritech: "The companies currently use two different methods of acquiring and maintaining switches, with Ameritech outsourcing its switch engineering functions and SBC performing these functions in-house. .... As with switching, Ameritech also outsources billing and Operations Support Systems (OSS) while SBC companies maintain their own data systems. These functions are subject to large economies of scale, and the merger allows the parties to reduce costs by combining and standardizing these operations. SBC estimates these savings at $227 million. ... For example, Ameritech will no longer have to outsource its data centers to a third party since SBC-PacTel operates its own data centers. Marginal costs of adding new Ameritech subscribers can be reduced through utilization of SBC data processing facilities."[64]

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[64] Gilbert and Harris Report, Paras. 43, 44, and 54.

The analysis of these gains from consolidation is incomplete and does not establish that efficiencies will result. Assume, *arguendo*, that Gilbert and Harris are correct in their assessment that the activities to be consolidated are subject to economies of scale. In that case, the addition of Ameritech's switch maintenance, billing, OSS, and other data center activities to SBC's internal capabilities will reduce the unit cost of these activities to SBC. However, the third party from which Ameritech currently purchases these activities will operate at reduced scale, and its costs will increase. The net effect on the industry-wide social costs of the activities may rise or fall, depending on the specific cost functions of SBC and of Ameritech's third-party suppliers.

Moreover, Ameritech's decision to choose a third party rather than SBC to supply these functions might indicate that SBC was not a cost-effective alternative. In this case, the transfer of Ameritech's business from the third party to SBC might well reduce overall efficiency. Had Ameritech self-provided the activities in question, consolidation might have permitted the cost savings referred to above. Given Ameritech's earlier decision to outsource these functions, the private gains to SBC of consolidation would represent a transfer of benefits from third parties to SBC, and not a new, net *public* benefit attributable to the merger.

Additionally, Ameritech's earlier decision to outsource these functions suggests that the efficiencies obtainable through consolidation are obtainable not only through the merger, but also through other contractual arrangements. For example, if Ameritech's third-party suppliers were more efficient than SBC,

efficiency would require that both firms use a third party to perform the relevant functions. This solution does not require that SBC merge with Ameritech.

Schmalensee and Taylor assert that "[t]he economics literature does not suggest that current Regional Holding Company (RHC) sizes exceed minimum efficient scale. Econometric evidence of scale economies among telecommunications firms much larger than SBC or Ameritech suggest positive scale economies with no evidence of diseconomies of scale."[65] However, they do not cite any econometric studies in support of this claim and, in fact, their conclusions are inconsistent with some recent econometric studies. Specifically, in the abstract to their recent paper, Ying and Shin conclude that the large LECs might be too large: "Using recent 1984-91 data, we find that LECs are not natural monopolies in the post-divestiture era. Having two firms produce the monopoly output could potentially result in over 20 percent cost savings."[66] In a follow-up study, Ying and Shin found that "the benefits to breaking up the monopoly outputs of existing local exchange carriers substantially outweigh the potential losses in efficiency."[67] These studies call into question the claim that the merger would produce scale and scope economies.

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[65] Schmalensee and Taylor Report, Para. 8.

[66] John S. Ying and Richard T. Shin, "Viable Competition in Local Telephone: Superadditive Costs in the Post-divestiture Period," Federal Trade Commission and University of Delaware Department of Economics, Working Paper: 94-8, Abstract, June 1994.

[67] John S. Ying and Richard T. Shin, "Unnatural Monopolies in Local Telephone," p. 181, *Rand Journal of Economics* 23:2, Summer 1992, p. 171-83.

In sum, the merger may not provide any net public benefits through consolidation of the functions identified by Gilbert and Harris, and, to the extent that there are net benefits, SBC has not explained why these benefits could not be fully realized using contractual arrangements. Moreover, the recent econometric analysis discussed above does not support the claim that there would be significant economies of scale from the merger.

5.4 Revenue synergies

Gilbert and Harris state that the merger is expected to result in increased revenue synergies of $778 million, and identify "increased penetration of value-added services" as being a source of increased revenue.[68] Specifically, Gilbert and Harris argue that Ameritech's Centrex experience can be transferred to Pacific Bell, while SBC's expertise in selling vertical features (such as Call Waiting and Caller ID), second lines, and data services can be transferred to Ameritech.[69] SBC claims that these revenue synergies are computed under the assumption that there would be no increase in prices after the merger.[70]

SBC does not provide sufficient information to determine the extent to which the predicted post-merger revenue growth would result from genuine innovation in

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[68] Gilbert and Harris Report, Para. 39.

[69] Gilbert and Harris Report, Para. 53.

[70] Affidavit of Martin A. Kaplan, Executive Vice President, Pacific Telesis Group, July 20, 1998, Para. 7 (henceforth Kaplan Affidavit).

marketing. For example, the Kaplan Affidavit claims that in the context of the earlier SBC/PacTel merger: "The Pacific experience is that the residence features per line has increased since the merger from about .7 per line to .9"[71] SBC does not describe any changes in marketing, advertising staffs or advertising expenditures, changes in product positioning, or any other merger-specific changes that were responsible for this growth, nor does it establish that the change from .7 to .9 features per line is greater than would be expected given the pre-merger trend.

This difficulty in evaluating SBC's claims arises with respect to all of its asserted revenue synergies. Without a detailed analysis of the sources of pre-merger disparities in the penetration of vertical and other services across states, as well as the specific changed practices that increased revenues after the SBC/PacTel merger, there is no basis for concluding that the merger would produce any revenue synergies. Indeed, the claimed synergies might simply result from the diversion of customers to SBC from its competitors resulting from anticompetitive behavior by the merged entity.[72] If this is the case, the claimed revenue synergies could hardly be counted as a public benefit of the merger. To the contrary, revenue synergies might well be an index of the public harm that would result from the merger.

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[71] Kaplan Affidavit, Para. 8.

[72] The exercise of market power need not result in increased prices. The increased penetration of Centrex services, vertical features, and data services could be obtained by degrading the quality of interconnection services, wholesale services, and Unbundled Network Elements (UNEs) that competitors require to offer comparable retail services to their customers. By degrading the services on which its competitors depend, SBC could gain market share at their expense.

6. The Competitive Risks of the SBC/Ameritech Merger to Interexchange and Local Exchange Markets

As noted above, SBC claims that the most significant benefits for consumers will arise from its ability to offer the entire array of telecommunications services to its largest customers, including interLATA and local exchange services, and that small businesses and residential consumers will eventually benefit. This section explains why the merger is likely to increase local exchange and interexchange rates above those that would likely prevail absent the merger.

ILECs, including SBC and Ameritech, provide an array of "access" inputs (originating and terminating access, UNEs, and the resale of the ILEC's local exchange service, among others) to IXCs, CLECs, and firms that offer both interexchange and local exchange services (combined service carriers or "CSCs"). In addition to selling inputs in this upstream market, the ILECs, either currently or prospectively, compete downstream with the IXCs, CLECs, and the CSCs for the patronage of retail customers, businesses and residences.[73]

As Professors Katz and Salop explain, because SBC and Ameritech have market power in the sale of access inputs to their downstream rivals, they have the

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[73] At the outset, it should be noted that SBC and Ameritech are currently not permitted to provide in-region interLATA service, which would seem to preclude SBC and Ameritech from implementing the National-Local Strategy at this time. Thus, the implementation of the National-Local Strategy implicitly assumes that the prohibition on SBC's entry into the in-region market for interLATA calls will be removed. This is made explicit in the July 22, 1998 Presentation to the Public Utilities Commission, State of Ohio, by representatives of SBC and Ameritech concerning their proposed merger. In the presentation, Mr. Ellis, General Counsel of SBC states: "This strategy only makes sense if you are able to link up those cities. The middle piece of the three part-strategy is to become a long-distance competitor. ...we have, from the beginning, viewed this transaction as absolutely requiring that we satisfy the 271 requirements and obtain long-distance relief in every one of our states." (pp. 22-23)

ability and incentive to disadvantage those downstream rivals by raising the price of these inputs. Because both the FCC and the states regulate interconnection prices, SBC and Ameritech may also choose to deny, delay, or degrade the provisioning of inputs to their downstream rivals, thereby disadvantaging those rivals in their attempts to attract consumers. In their declaration, Professors Katz and Salop explain that these anticompetitive incentives are large and that the SBC/Ameritech merger would heighten those incentives. What follows summarizes their views.

First, the ILECs generally, and SBC and Ameritech in particular, likely have substantial market power in the supply of access inputs. For example, the current prohibition on RBOC provision of in-region interLATA communications is based on serious concerns that RBOCs can and will use their control of essential facilities to exclude, or discriminate against, competitors in the interLATA market. The rationale for this prohibition is clearly described in the history of the Telecommunications Act of 1996 and in the longstanding policy of the FCC to regulate access and interconnection services offered by ILECs.

The Telecommunications Act of 1996 (Section 271) recognizes the ability and the incentive of the RBOCs to leverage their control over essential local exchange facilities to behave anticompetitively in the long-distance market, and thus prohibits RBOCs from providing interLATA services within their regions until they are subject to some competitive discipline in the sale of access inputs.

Similarly, the Commission has clearly expressed ongoing concern with the potential that ILECs have to frustrate the growth of local exchange competition. For example, the FCC has noted that:

> Because an incumbent LEC currently serves virtually all subscribers in its local serving area, an incumbent LEC has little economic incentive to assist new entrants in their efforts to secure a greater share of that market. An incumbent LEC also has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable conditions for terminating calls from the entrant's customers to the incumbent LEC's subscribers. [74]

In summary, the supply of access inputs is characterized by an absence of current and prospective competition.[75] Professors Katz and Salop conclude that, for the foreseeable future, SBC and Ameritech will have the ability to disadvantage their downstream IXC, CLEC, and CSC rivals by denying, delaying, or degrading the provisioning of access inputs to them. The exclusionary behavior might result from (among other possibilities) decreasing the technical quality of interconnection or delaying the installation of new lines, the provisioning of UNEs or collocation cages, or the repair of the rival's leased facilities.

The principal effect of the merger would be to increase the control that a single entity has over access lines and other resources that are needed by the IXCs,

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[74] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, CC Docket Number 96-98, (August 8, 1998), Para. 10.

[75] Hayes Declaration, Para. 9.

CLECs, and the CSCs; as a result, the merger threatens existing competition in IXC services and emerging competition in CLEC and CSC services.

If an ILEC can divert customers from its downstream rivals to its own service (local exchange service, interexchange service, or some combination), the ILEC gains the profit margin earned on customers that switch to it from its rivals. However, for every customer that it gains from its rivals, the ILEC loses the profits that it previously earned from the sale of inputs to them. If the downstream (retail) margin for an additional customer diverted to the ILEC exceeds the upstream (wholesale) margin from the sale of inputs to the rival, the ILEC has the incentive to divert customers from the rivals to itself.

For the CSC illustration used in their Declaration, Professors Katz and Salop calculate the monthly local and long-distance revenues generated by the average single-line business customer. They subtract from the revenues the ILEC's monthly costs of providing these services. The difference between the monthly revenues and costs is the retail margin captured by the ILEC for every customer shifted from a CSC to itself.

This retail margin gained on each subscriber diverted is then compared to the upstream margin on the sale of access inputs lost as a result of the diversion. Professors Katz and Salop assume that the CSC owns its own long-distance network, collocates the necessary equipment in the ILEC's central offices, connects the collocated equipment to its interexchange nodes using CAP transport, and

purchases unbundled loops from the ILEC. The CSC's only incremental purchases from the ILEC are the unbundled loop.

Based upon the preliminary data available to them, Professors Katz and Salop conclude that the downstream (retail) margin exceeds the upstream (wholesale) margin by a considerable amount. Indeed, they calculate that this would be so even if a substantial fraction of the CSC's lost subscribers do not shift to the ILEC.[76] Thus, in addition to having the ability to disadvantage its downstream rivals, the ILEC has the incentive to do so as well.

Recent decisions by State Commissions to deny petitions by RBOCs seeking to provide interLATA service in accordance with Section 271 of the Act provide concrete evidence of such incentives. One news report characterizes the Texas Public Utility Commission's decision as follows: "Harshly criticizing SW Bell for blocking local exchange service competition, the PUC voted 3-0 not to support SW Bell's efforts to provide in-region interLATA services."[77] One commissioner stated that the record was "replete with examples of SW Bell's failure to meaningfully negotiate, reluctance to implement the terms of arbitrated agreements, lack of cooperation with customers, and evidence of behavior which obstructs competitive entry ...".[78]

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[76] Katz and Salop Declaration, Paras. 52-53.

[77] "Texas PUC Nixes SW Bell's Bid To Offer InterLATA Services," *Telecommunications Reports*, May 25, 1998, p. 25.

[78] Id.

The evidence from California is consistent with that from Texas. In a final staff report issued on October 5, 1998, the California PUC found that Pacific Bell had complied with only four of the 14 checklist items enumerated in Section 271 of Telecommunications Act of 1996 and that "Local competition is floundering at the present time."[79]

Similarly, in its recommendations for actions that regulators should take to promote Digital Subscriber Line (DSL) competition, Northpoint complained that SBC/PacTel was warehousing collocation sites for its own DSL service, that SBC/PacTel and other RBOCs were subjecting Northpoint to excessive delays in providing caged collocation space, and that the ILECs charged excessive rates for collocation.[80] In contemplating the future of ION, Mr. Brauer of Sprint has echoed these concerns.[81]

Following hearings and her review of thousands of pages of evidence, a NYPSC Administrative Law Judge found that Bell Atlantic-New York had not met its burden of proof with respect to its Prefiling Statement, and noted both the difficulty in obtaining services and elements in a timely manner and the clear lack of OSS

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[79] *Pacific Bell (U 1001 C) and Pacific Bell Communications Notice of Intent to File Section 271 Application for InterLATA Authority in California*, California Public Utilities Commission Telecommunications Division Final Staff Report, October 5, 1998, pp. 7, 10.

[80] "Northpoint Communications' Proposed Remedies for Promoting DSL Competition" (undated), pp. 1-4.

[81] Affidavit of Kevin E. Brauer, October 12, 1998, pp. 12-18.

parity.[82] The same judge also recently found that "as a matter of fact on this record" that none of BA/NY's proposed UNE combination methods constitute a nondiscriminatory form of obtaining and combining unbundled elements.[83] The affidavit filed with the New York Public Service Commission on September 28, 1998, by Michael Nelson explains some of the problems that Sprint has encountered reselling Bell Atlantic's local service.[84] These problems include OSS variances from national standards and Sprint's not receiving first quarter 1998 performance measurements upon request, both of which are contrary to the conditions imposed by the FCC in connection with its approval of the Bell Atlantic/NYNEX merger. None of the RBOCs has yet succeeded in obtaining approval for a Section 271 application.

While these accounts are consistent with the view that the ILECs have adopted strategies to disadvantage their downstream rivals, the extent of exclusionary behavior is likely to increase, perhaps substantially, if the SBC/Ameritech merger is approved. Specifically, the merger would increase the incentive for exclusionary behavior by permitting the internalization of important

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[82] See New York Public Service Commission, Case 97-C-0271, *Petition of New York Telephone Company for Approval of its Statement of Generally Available Terms and Conditions and Draft Filing of Petition for InterLATA Entry,* Ruling Concerning the Status of the Record, Issued July 8, 1997.

[83] New York Public Service Commission, Case 98-C-0690, *Proceeding on Motion of the Commission to Examine Methods by which Competitive Local Exchange Carriers can Obtain and Combine Unbundled Network Elements*, Proposed Findings of Administrative Law Judge Eleanor Stein, August 4, 1998 at 10.

[84] See Affidavit of Michael J. Nelson, attached to Comments of Sprint Communications Company, L.P., State of New York Public Service Commission, Case 97-C-0271, September 28, 1998 (henceforth Nelson Affidavit).

anticompetitive spillovers and, by so doing, would increase the incentive and ability of SBC/Ameritech to engage in such behavior.

For example, suppose that SBC currently provides within-region long-distance service and provides terminating access to Ameritech's long-distance affiliate as well as other IXCs.[85] In addition, suppose that absent the merger, SBC impairs the quality of terminating access to all IXCs, excluding Ameritech's long-distance affiliate. As a result, some customers within SBC's region who would otherwise have subscribed to one of these IXCs instead chooses to subscribe to SBC's long-distance service. In addition, the degradation of terminating access to Ameritech's long-distance rivals also would benefit Ameritech's long-distance affiliate. As a result, Ameritech would gain an artificial advantage in competing in its region.

Before the merger, SBC has no incentive to consider the benefits that its exclusionary behavior generates for Ameritech. After the merger, however, SBC would take the spillover effects on Ameritech's profits into account, and thus would have a greater incentive to degrade interconnection to other IXCs.

Most obviously, anticipating its entry into interLATA service in its local service territory, the merged firm would have enhanced incentives to degrade the quality of access to long-distance rivals even before it obtained the authority to offer interexchange services, and these incentives will increase as access charges fall to

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[85] For its long-distance service, the CSC is likely to require terminating access in both SBC's and Ameritech's territories.

more cost-based levels. Until local markets are vigorously competitive, the merged firm will also have the ability to disadvantage its rivals.

Similarly, the merger is likely to increase the incentives for SBC to engage in exclusionary behavior towards CLECs and CSCs. This occurs because there may be scale and scope economies attained by a CLEC or CSC operating in multiple markets. If this type of carrier is competitively harmed in one market, its ability to compete in other markets is reduced. When SBC successfully engages in exclusionary behavior towards these competitors, it raises the costs or reduces the service quality of these competitors in SBC's territory. But as a result of the exclusion, the competitors' ability to attract customers in other geographic areas may also be impaired. Indeed, the linkages across markets may be sufficiently strong that a CLEC or CSC that experiences harm in one market may not find it profitable to enter any market.

As one example, the higher costs or degraded service quality imposed on a CLEC in SBC's territory will result in the CLEC obtaining fewer customers in SBC's territory than it would otherwise attract. As a result, the CLEC may engage in less national advertising or invest less in upgrading its service quality than otherwise, and will be a less aggressive competitor in other geographic areas, which would likely include the Ameritech territory. Ameritech will then experience less competition and greater profits.

As another example, there may be functionality on the CSC's network that is only available to its customers. Like many other telecommunications services, the

value to any particular customer of the functionality may increase as the number of other CSC customers with that functionality increases. Thus, the more customers a CSC can attract, the greater the value of the CSC to each customer. In this case, if SBC disadvantages the CSC in its own territory, the CSC captures fewer customers and its service will become less attractive to potential subscribers in Ameritech's territory too.

In these examples, SBC's exclusionary behavior generates a spillover benefit for Ameritech. A merger between SBC and Ameritech internalizes this anticompetitive spillover and increases the incentives for exclusionary behavior. Absent the merger, SBC does not share in any of the additional profits that its exclusionary behavior generates for Ameritech. With the merger, SBC will take these additional profits into account in choosing the extent of its exclusionary conduct. The amount of exclusion will be higher because of the additional profits earned by Ameritech. Thus, the merger would likely increase the harm to competition in the market for local services.

In addition to increasing the incentives for exclusionary behavior, the merger would increase the ability of SBC/Ameritech to engage in such conduct against its rivals. As discussed by Professor Farrell and Dr. Mitchell, the regulator's ability to detect exclusionary behavior would be reduced because there will be one fewer firm against which SBC's behavior could be gauged. Thus, there would be greater uncertainty about the extent to which deviation from (say) some average measure of performance is a statistical aberration or indicates exclusion. Moreover, because

the post-merger SBC/Ameritech would now be a larger component of any calculated average measure, the average measure itself would worsen, providing the merged firm with greater scope to engage in exclusionary behavior. In addition, the declining average increases the scope for exclusionary conduct for other ILECs as well, another anticompetitive spillover effect from the merger. The usefulness of the benchmarks will deteriorate even further if the recently-proposed Bell Atlantic/GTE merger is approved, providing SBC/Ameritech with even greater scope for conduct that harms competition.

It is also important to observe here that conditioning approval of the merger on an agreement by the parties to accept certain obligations in their dealings with rivals is unlikely to alleviate these competitive concerns. Indeed, Sprint apparently continues to experience considerable difficulty in obtaining services from Bell Atlantic despite the company's obligation to provide these services under the terms of the FCC's approval of the Bell Atlantic/NYNEX merger.[86]

7. The Merger Would Eliminate SBC and Ameritech as Potential Local Exchange Entrants Into Each Other's Service Territories

The proposed merger would eliminate SBC as a potential entrant as a local exchange carrier into Ameritech's service territories and Ameritech as a potential entrant as a local exchange carrier into SBC's service territories. SBC and Ameritech have claimed that the elimination of each as a potential entrant into the

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[86] See Nelson Affidavit.

service territories of the other would not adversely affect consumers because there are so many other potential entrants into the supply of local exchange service. However, because they possess a number of important competitive advantages, the merging firms may well be among the most likely potential entrants.

First, both SBC and Ameritech have extensive experience as suppliers of local services, including experience in the engineering, design, marketing and operation of extensive local telephone networks serving all businesses and residences. Second, both possess fully functioning and time-tested OSS and billing systems that are critically important to the provision of local exchange and exchange access services. The significance of OSS has been most apparent in the Section 271 applications rejected by the FCC.

Third, both SBC and Ameritech possess a clear marketing message based on scores of years of local service provision and brand names that are well known in adjacent service territories. Fourth, the geographic proximity of SBC and Ameritech service territories in a number of geographic areas would allow each to take advantage of limited scope economies that they have claimed (but not established) as an efficiency benefit of the proposed merger.

Finally, SBC and Ameritech are likely to be particularly potent entrants because they have first-hand knowledge of the kind of input provisioning of which an ILEC is capable. If, for example, Ameritech were to attempt to impede SBC's entry by claiming that a service demanded by SBC could only be provided in a particularly

costly way, SBC would be in an excellent position to evaluate the validity of that claim by virtue of its own ILEC experience.

At least in the recent past, SBC's and Ameritech's expansion plans have been consistent with exploiting these advantages. For example, in a report prepared on behalf of SBC in 1996, Dr. Richard Gilbert noted that SBC considers expanding into new areas "only where it has some combination of the following existing assets: (1) a network infrastructure, (2) an existing customer base, and (3) brand-name recognition. Thus, SBC is considering providing local exchange service in competition with Ameritech in the Chicago area, where SBC has a significant cellular presence."[87]

In addition, less than a year ago, Ameritech had indicated that it would enter the St. Louis market as a local exchange carrier.[88] In announcing Ameritech's plans, Thomas E. Richards, executive vice president of its Communications and Information sector stated that "[t]his expansion represents a huge win for consumers. ...[and] a tremendous opportunity for Ameritech to grow through competition. ...The Ameritech brand is already strong [in St. Louis], as evidenced by our superior customer growth in cellular and paging."

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[87] Richard J. Gilbert, "Response to Opponents' Comments Concerning the Proposed Pacific Telesis - SBC Merger," August 7, 1996, p. 7 (note omitted).

[88] "Ameritech to Expand in St. Louis, Will Give Customers Competitive Choice in Local, Long Distance Phone Services," Ameritech Release, November 6, 1997. See the Hayes Declaration for a more extensive discussion of these plans.

In this regard, it is interesting to note that, if the merger were not approved and SBC and Ameritech each entered only the 15 largest out-of-region markets, 7 cities — Washington, Boston, Minneapolis-St. Paul, Atlanta, Phoenix, Philadelphia, and New York — would have two entrants rather than one, and several cities in their home regions — Chicago, Detroit, and Milwaukee (Ameritech); and Dallas, Los Angeles, Houston, St. Louis, Orange County, and Kansas City (SBC) — each would get one entrant that would be eliminated by merger.[89] Thus, the merger might actually reduce competition in these 16 cities.[90] This is inconsistent with SBC's assertion that the merger would not have any anticompetitive effects.

8. Benchmarking

Regulatory policy generally, and the implementation of the Telecommunications Act of 1996 in particular, requires the Federal Communications Commission to reach complex decisions regarding, for example, the pricing of unbundled network elements and the quality of network access. In making such decisions, the Commission inevitably faces a critical, pervasive problem: incomplete information about the true costs and capabilities of the regulated firm.[91] In order to overcome this problem, the Commission and state regulators can and do use comparisons of one RBOC's costs, and other measures of performance, with those

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[89] Cities are from the Carlton Report, Table 1, p. 18.

[90] A more detailed analysis of actual and potential competition in the SBC and Ameritech regions can be found in the Hayes Declaration.

[91] See Farrell and Mitchell Declaration, esp. Section I.C.

of other RBOCs and comparably sized LECs. The SBC/Ameritech merger would reduce the quantity and quality of such information that is available to regulators and, therefore, their ability to employ "benchmarking" as a regulatory tool. This would occur because the merger would further reduce the already small number of RBOCs whose performance can be used to gauge the performance of any particular RBOC (or other comparably sized ILEC). This section summarizes the Declaration of Professor Joseph Farrell and Dr. Bridger M. Mitchell, which analyzes the impact of the proposed merger on the ability of regulators to rely on benchmarking as they implement procompetitive public policies. Farrell and Mitchell explain the various forms that benchmarking may take and provide an extensive set of examples of their use by telecommunications and other regulators.

8.1 Average practice benchmarking

In average-practice benchmarking, a regulator uses an industry average to determine a maximum price, a minimum quality standard, or some other performance measure for a regulated firm.[92] In setting a maximum price benchmark (i.e., price caps), or determining customer revenue per line for high-cost support plans, for example, each regulated firm only partially determines the industry average. As a result, only a fraction of the cost savings or revenue increases achieved by one firm will be reflected in the subsequent period's industry average.

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[92] See Farrell and Mitchell Declaration, Section II.A., for a discussion of the use of average-practice benchmarking.

This allows the firm to retain a portion of the reward for its innovations and provides the firm with an incentive to innovate.

Average-practice benchmarks typically are based on information from several comparably sized and similarly situated firms. The process of averaging serves to overcome the "noise" in individual observations, thereby permitting the regulator to be more confident about the benchmark used to judge any individual firm's performance.

Farrell and Mitchell identify a number of important examples in which average-practice benchmarking has been used by regulators. The best known example involves the use by the FCC regulators of estimates of average industry productivity improvements in setting price cap formulas. More recently, the FCC has indicated that it will use average revenue per residential line in computing the appropriate universal service subsidies in high-cost areas.

8.2 Best-practice benchmarking

In best-practice benchmarking, regulators seek to identify best practices in an industry and induce the firms they regulate to adopt these practices.[93] Best-practice benchmarking may be used either for qualitative characteristics, such as determining whether an ILEC should make available particular forms of interconnection or access to particular network elements, or quantitative

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[93] See Farrell and Mitchell Declaration, Section II.B., for a discussion of the use of best-practice benchmarking.

characteristics, such as regulating the level of pricing for services used by competing carriers. Farrell and Mitchell note that ILECs often differ in the choices they make, very possibly because they have different attitudes toward cooperation. Consequently, observing this diversity of practices and requiring all ILECs to follow the best-practice can significantly improve industry performance.[94]

Farrell and Mitchell cite a large number of examples of the use by regulators of best-practice benchmarking. A graphic example involves the FCC's use of Ameritech's willingness to employ the Location Routing Number (LRN) method of implementing local number portability. After Ameritech demonstrated the feasibility of LRN, the Commission required that other ILECs employ the same method. As another example, the Commission concluded that interconnection or access to a particular point on a LEC network is evidence of the technical feasibility of providing the same or similar interconnection in another ILEC network. As a final example, relying on the observation that US West currently offers cageless collocation and that SBC permits CLECs to share collocation space, the Commission has requested comments to determine whether such arrangements should be presumed to be technically feasible at other LEC premises.

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[94] Farrell and Mitchell Declaration, Section II.B.

8.3 "Heightened scrutiny for poor performance" benchmarking

Regulators also may use comparative data to identify problem cases.[95] Such information may then be used to identify sub-standard performance by ILECs and regulators may subsequently require improved performance or impose sanctions on those firms. This should both directly improve performance of individual ILECs and provide incentives for them to avoid poor performance that eventually would be detected.

Farrell and Mitchell report that the FCC has used "heightened scrutiny for poor performance" in disallowing some ILECs' high charges for physical collocation services, in assessing the overhead rates imposed by ILECs in providing interconnection, and in determining whether the penetration ratios for non-primary residential lines were correctly represented by ILECs in assessing access charges. The authors also note that the Department of Justice has employed this form of benchmarking in assessing the reasonableness of the speed with which RBOCs had complied with their equal access requirements.

8.4 The impact of the merger on benchmarking

Farrell and Mitchell discuss the effects of mergers on benchmarking under three headings. First, they demonstrate that there are adverse effects even ignoring the effects of mergers on the incentives of the firms. Next, they analyze the adverse

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[95] See Farrell and Mitchell Declaration, Section II.C., for a discussion of the use of this type of benchmarking.

unilateral incentive effects on the performance of firms subject to benchmarking. Finally, they examine the increased likelihood of coordinated effects as the result of mergers.

Loss of Information Effects

When a merger leads to more aggregated reporting, the Commission observes less diversity in ILEC practices and loses valuable information that it would otherwise have available for use in establishing performance benchmarks. In many cases, the merged firm may adopt a common practice for pricing of services and supplying network components. Even when the merged firm reports company-by-company results, the data can be less useful than information obtained from independent firms.

Farrell and Mitchell consider the likelihood that at least one ILEC will report a practice that is cooperative with competitors. They find that mergers of large ILECs significantly reduce the probability that such a favorable practice will be observed even if the mergers had no incentive effects. Similarly, the reduced diversity in observed ILEC practices increases the uncertainty inherent in using a benchmark to determine, for example, whether to disallow some ILECs direct costs of collocation services.

Unilateral Effects

The establishment of regulatory benchmarks effectively creates 'competition by comparison' between firms that do not directly compete with each other in the

same geographic markets.[96] This form of competition is akin to product market competition in one important respect. A merger between firms that are not actual or potential competitors in any product market may nonetheless create incentives for unilateral and coordinated actions that harm consumers.

Under average-practice benchmarking, a merged firm will have a larger weight in the computed industry-wide average, and its decision to undertake a cost-saving innovation will have a larger impact on the industry-wide average that regulators will use in the future as a yardstick. Indeed, in its Bell Atlantic/NYNEX order, the Commission itself expressed concern that the merger increases the relative weight of each company's actions on average performance, and that that increase will adversely affect the incentives of the merged firm to become more effective.[97]

In addition, the SBC/Ameritech merger would likely result in the merged firm's adopting common practices or uniform standards. If this were to occur, there would be (at least) one fewer independent, firm-specific observation available to regulators in computing the industry-wide average. Such a loss of information handicaps regulators. For example, regulators would inevitably be less confident in identifying unusually poor performance or concluding that it is unreasonable. With poorer information, regulators might have to accept poorer performance.[98]

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[96] Farrell and Mitchell Declaration, Section III.

[97] Merger Order, Para. 150.

[98] Farrell and Mitchell Declaration, Section III.C.

Under best practices benchmarking, if the practice that Ameritech by itself would prefer reduces the profits of SBC, post-merger, Ameritech would account for that fact in deciding whether to adopt the practice. If there were numerous, equally situated ILECs, the effect of this would be small. However, the number of independent observations would fall from five to four as a result of the merger so the adverse incentives are likely to be large.[99]

Coordinated Effects

Farrell and Mitchell conclude that substantial decreases in the number of large ILECs can significantly increase the threat that ILECs will develop a common understanding on such issues as cooperating with competitors and avoid "breaking ranks."[100] One reason is that a reduction in the number of players reduces the probability that one or more will want to be a maverick. In addition, an ILEC considering whether to forego an action it individually would prefer, but that also would break a united front that would be valuable on another issue, must consider whether its action would provoke a break in the united front. Because the probability that the united front would break down in any event will decrease as the number of players falls, a merger makes it more likely that the ILEC would choose to sacrifice its preferred position in order to avoid breaking ranks. In this way, the merger reduces the efficacy of best-practice benchmarking. Indeed, in reviewing

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[99] The proposed merger between Bell Atlantic and GTE would reduce this number further.

[100] Farrell and Mitchell Declaration, Section III.B.

the Bell Atlantic/NYNEX merger, the Commission concluded that reducing the number of Bell Companies makes it easier to coordinate actions among them.[101]

It is also worth noting that Ameritech had sometimes been regarded as a "maverick" among the large ILECs in proposing and adopting best-practice access solutions for potential downstream rivals.[102] By eliminating Ameritech as a maverick, the merger would make the search for these solutions more difficult.

9. Market Power in Local Exchange and Exchange Access Markets

If the provision of local exchange and access services were competitive, the merger's likely anticompetitive effects, as described by Professors Katz and Salop and by Professor Farrell and Dr. Mitchell, would not be of antitrust significance. However, the proposed merger of SBC and Ameritech raises significant antitrust concerns because the merging parties control essential facilities that are required to produce a range of communications services, including competitive local services, interexchange communications services, and data services such as Internet access. In his Declaration, Dr. Hayes concludes that SBC and Ameritech possess market

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[101] Merger Order, Para. 11.

[102] Terry D. Appenzeller, Ameritech Vice President – Open Market Strategy, characterizes his testimony as follows: "In this affidavit, I intend to demonstrate that Ameritech has been a leader among incumbent local exchange carriers in the facilitation of local exchange competition, and believes it has met the requirements of the local exchange competition section of the Act, Section 251" (Para. 7). Ameritech began working with CLECs on plans for opening the local exchange in 1992, and filed the Ameritech Customers First Plan, which developed unbundled offerings such as loops and interconnection arrangements, in March 1993, almost three years before passage of the Act. Ameritech jointly chaired the Number Portability Workshop beginning in early 1995 (Para. 8). The affidavit goes on to establish that, compared to other RBOCs, Ameritech has been a leader in opening its network. By contrast, SBC has been one of the strongest opponents of the local competition sections of the Act, and has brought suit to have portions of the Act voided on the grounds that some provisions constitute a bill of attainder.

power in the sale of local exchange and exchange access services, and are likely to retain that power for some time to come.[103]

In particular, Dr. Hayes considers the relative position of ILECs as measured by their share of total local exchange residential and business lines in four SBC and Ameritech states (Arkansas, California, Michigan, and Oklahoma). On average, the ILEC in these states accounts for about 98% of residential lines and 95% of business lines. Dr. Hayes also considers the position of the ILECs as measured by their share of network minutes of use; in the five Ameritech states and California, the ILEC shares average about 98.6% and the share is never less than 96%. These statistics do not indicate that the SBC and Ameritech territories have been subject to substantial CLEC entry.

While these shares are evidence of the continuing dominance of SBC and Ameritech, the shares may nonetheless understate that dominance since they include resale of the ILEC's service by the CLEC. As Dr. Hayes points out, "[b]ecause resale rates are not based on the underlying costs of the facilities, resale competition can do relatively little to drive retail rates down towards cost. Facilities-based competitors also represent alternative sources of access services, while resellers do not serve this function."[104] If resold lines are "counted" as part of the ILEC's share of local exchange lines in the four SBC and Ameritech states identified

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[103] Hayes Declaration, Para. 9 and Section IV, footnote omitted.

[104] Hayes Declaration, Para. 39.

above, the ILECs' average share of residential lines exceeds 97.8% and the ILECs' average share of business lines exceeds 95.3%.[105]

Equally important, Dr. Hayes observes that CLEC facilities in the SBC and Ameritech regions are almost always concentrated in major urban areas and serve large business customers. Thus, while there may be growing competition for large businesses, that competition has yet to increase the rivalry for other businesses and for residential services.

Finally, the failure of any of the ILECs to be found in compliance with Section 271 of the Act suggests that the opening of local exchange markets to competition is not likely to occur in the near term. Given the incentives that the ILECs have to discourage emerging local competition, Dr. Hayes concludes that "the need for on-going regulation would not soon end."[106]

In sum, the Commission cannot rely on either the current degree of competition with the ILEC or the development of near-term competition to eliminate the heightened incentives that a combined SBC/Ameritech would have to discourage local exchange and interexchange competition. Further, the combination would reduce the efficacy of the Commission's benchmark regulation.

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[105] Hayes Declaration, Para. 32.

[106] Hayes Declaration, Para. 53.

10. Conclusion

The proposed SBC/Ameritech merger is not in the public interest. It would increase the significant incentives that SBC and Ameritech already have to foreclose the entry of CLECs, especially those that wish to offer innovative communications services. It would also increase both the ability and incentives of the merged company to engage in anticompetitive behavior toward IXCs when and if SBC and Ameritech are permitted to offer long-distance service. Moreover, this situation will persist for the foreseeable future as would-be competitors continue to rely on access to facilities that can be provided only by SBC and Ameritech and remain dependent on interconnection to SBC and Ameritech customers.

In addition, the proposed merger would reduce substantially the ability of the Federal Communications Commission and other regulators to employ benchmarking as a policy tool. By reducing the number of independent ILECs, the merger would increase the impact of any individual ILEC on average industry performance. This would reduce the incentive of all ILECs, not just SBC and Ameritech, to improve their performance because it would reduce the reward from such improvements. The proposed merger would also reduce the ability of regulators to use best-practice and worst performance benchmarks because it would reduce their confidence that the observed behavior of any particular firm truly reflected anticompetitive behavior. Given the widespread use of benchmarking by telecommunications regulators, these effects are likely to be large.

While denying that the proposed merger would have any competitive effects, SBC and Ameritech have also claimed that it would produce substantial efficiencies. In particular, SBC and Ameritech claim that the merger would permit them to pursue a NLS and that they would, or could, not do so without the merger. However, the claim that the merger is needed in order to permit the Strategy to be pursued is dubious. SBC and Ameritech do not convincingly explain why they can only compete effectively for large business customers that are headquartered in their service territories, nor why they would experience significant cost disadvantages if they could pursue only the customers headquartered in their separate service territories. Indeed, their claims are inconsistent with the experience of Competitive Access Providers in competing successfully for large business customers without a substantial base of such customers to "follow."

Finally, the claims of efficiencies from the merger that are unrelated to the National Local Strategy are similarly unconvincing. For example, neither economic theory nor empirical evidence indicates that Research & Development will be more effectively carried out if SBC and Ameritech are permitted to merge. Moreover, it is likely that the merger would increase the risks experienced by SBC's and Ameritech's local customers, not reduce them as the parties have claimed.

For all these reasons, the proposed merger between SBC and Ameritech should be rejected.